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SUBJECT: AUSTRALIA TACKLES EXECUTIVE PAY - DON'T EXPECT TOO
GREAT A CHANGE

¶1. (SBU) Summary. Prime Minister Rudd has been outspoken on the need for reform of executive pay to better balance compensation with risk management. Australian regulators are working on high-level general principles on executive pay with an eye on what emerges as the international consensus. This would extend existing rules on corporate governance, risk management, and capital requirements, focused on the structure of executive pay and on the incentives built into compensation plans. The principles will seek to encourage behavior by management that supports the interests of beneficiaries. This will not include specific dollar figure caps on salaries. We expect any changes will be moderate and principles-based. End summary.

PRIME MINISTER OUTSPOKEN ON EXECUTIVE PAY

¶2. (U) As the global financial crisis has intensified, the issue of executive remuneration has received great attention in Australia. Prime Minister Kevin Rudd has been very active, saying in speeches and media interviews over the past three months that people are "fed up and angry" with "outrageous packages paid to financial company executives". He has stated that what is needed is a set of principles for executive remuneration that balances pay levels with risk management, and has stressed the importance on doing this in the international context as well; Australia is taking an active role in the Financial Stability Forum (FSF) and G20. Rudd has, however, refused to be drawn into making any judgments on actual dollar figures. He has said that the GOA, through the Australian Prudential Regulatory Authority (APRA), would work through details for changes in rules to discourage excessive risk taking.

¶3. (U) There have been some shareholder challenges at annual general meetings (AGM) against planned executive compensation; Telstra's executive compensation plan last year failed to gather a majority of votes of those present at its AGM, and Toll Holdings (owners of Virgin Blue and other companies) has also seen votes disapproving its executive compensation plan. However, these are nonbinding votes and most large institutional shareholders don't bother to show up at AGMs, leaving the floor to small retail investors. This dissatisfaction (and the PM's public comments) comes despite the fact that top executives at major Australian industries generally receive lower total compensation than some of their global counterparts. The biggest earners are at Macquarie Bank (CEO Nicholas Moore received around A\$27 million, US\$17.5 million at current exchange rates, in 2007) and Babcock & Brown - Australia's two main investment banks, now both in some difficulty, are outliers on the Australian pay scale. Chief executives at Australia's Big Four banks - Westpac, Commonwealth Bank, ANZ, and National Australia Bank - for example each earn around A\$8-9 million (US\$5.2-5.9 million), relatively low compared to other major banks with

large international presences. Not surprisingly, The Australian business community has strongly resisted calls for limits on executive compensation. They argue that compensation is subject to shareholder review and approval. In addition, business groups insist that limits would hamper their ability to attract and retain talent. Financial sector contacts point out that Australian financial companies compete with foreign jurisdictions to attract Australians as well as foreigners - a large difference in compensation can lead talented people to move offshore.

REGULATOR PLANS

14. (SBU) Econoff met with APRA executive general manager for policy research and statistics Charles Littrell on December 11 to discuss APRA's efforts on executive pay. (APRA is the prudential regulator for the financial services industry, with the goal of ensuring banks, insurance companies and other financial institutions can meet their obligations and provide a stable, efficient and competitive financial system.) Littrell noted APRA already has some rules related to executive compensation, built into its accreditation rules - as a precondition to accreditation, there has to be some link between pay and the risk and capital-setting system. Also, rules governing internal accounting of business units include links to performance.

15. (SBU) Littrell noted with a joke that in fact the Prime Minister cannot "instruct" APRA to do anything. But APRA was already considering, since early in 2008, making some changes on executive pay; Rudd's comments and the global financial

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crisis have helped develop a consensus that the time is right for such changes. APRA already has a good handle on the risks and incentive. Littrell said that good rules for pay and risk management are already well-known by industry - they just aren't always applied.

16. (SBU) APRA's approach, Littrell said, was to develop a principles-based framework for APRA-regulated entities, including listed and unlisted companies, locally- and foreign-owned companies, and branches of foreign companies. Essentially it would extend existing corporate governance, risk management, and capital requirements that are already in place. Littrell noted there are two areas of focus for executive pay: "they are paid too much" and "they are paid in ways that are contrary to the interest of others". APRA's focus is solely on the second complaint, not the first. As Rudd has urged, APRA will focus on the structure of executive pay and on the incentives built into compensation plans. It will seek to encourage behavior by management that supports the interests of beneficiaries - depositors, policy holders, retirement fund members. (An APRA press release from December 9 discusses this, and can be found at www.apra.gov.au/media-releases/08_32.cfm)

17. (SBU) However, Littrell said APRA wasn't ready to say much about what they are actually developing now. There are drafts which he said satisfied APRA and the GOA. But APRA wants to wait to see what comes up in the international arena first before announcing any domestic steps. Australia has been "marginally more conservative" on these issues in the past, Littrell noted, and he suspects the international consensus will be "less robust" than what APRA is thinking, so they will adapt as needed. Littrell noted that management and boards are usually unified in discussing issues with APRA, but thought in this instance it would be interesting to see if this remains the case. On this issue, APRA and boards may side together against management, sharing the interest in ensuring executive pay and risk management are done in a way that protects beneficiaries and society from excessive risk taking. Again APRA's main concern is that executives not be paid to simply "roll the dice."

¶8. (SBU) Econoff also met with Lynne Thompson, a senior lawyer in the Australian Securities and Investments Commission (ASIC); ASIC has been assisting because APRA has a tiny policy shop. Any rules coming out of this would be applied to the non-APRA regulated arena by ASIC. She said that once new principles are promulgated by APRA, ASIC would be forward-looking in issuing guidance on executive pay - not waiting to see misconduct. Thompson noted that there have been other actors on executive remuneration, such as the Australian Stock Exchange (ASX), with some high-level listing rules covering executive pay.

¶9. (SBU) Thompson also noted that ironically, depending on how principles are developed, there could be results that could support pay raises. For example, if under new principles Australia's Big Four banks decided to compare executives to their peers at other AA-rated international banks, they would find their compensation is lower on average.

¶10. (SBU) Comment: So far, beyond the predictable bashing of overpaid bosses in Australia's newspapers and on talk radio, there has been little reaction to Rudd's comments or APRA's plans. One banker told Econoff that he was confident any changes would be principles-based rather than taking the form of direct rules on what can or cannot be done; he said APRA and the GOA also well understood that it would do no good to come up with overly restrictive or prescriptive rules that could make it harder for Australian businesses to compete for talent. ASIC's Thompson also said she did not expect much opposition from "the big end of town" on executive pay if it is based on principles. APRA's Littrell also emphasized that any plan will only emerge after extensive consultations with its regulated companies. In the end, we expect APRA will issue principles that will try to make sure incentives and risk management are better balanced. It should be enough for Rudd to claim victory, but will represent more a fine-tuning of existing risk management and prudential rules rather than sweeping changes. End comment.

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